To: NCUA Board

From: Steven Stofferahn, CEO
Air Guard Fed. Credit Union
Charter # 10905

Re: Advance Notice of Proposed Rulemaking

The following is my positions on the ANPR issued by NCUA concerning the future of the Corporate Credit Union System. I have adopted most of the following supporting documentation from information I have gathered throughout these last few months.

The Air Guard FCU is very dependent on our Corporate as a primary provider of cost effective Payment processing, liquidity and investment functions among many other things. I believe it would be extremely difficult for us to continue to operate if the Corporate system is completely eliminated. We rely on our corporate to assist us in many complex issues that we are unable to complete internally due to our lack of resources in assets, human resources and costs.

I believe the Corporate system must be changed and hope my comments will assist you in deliberating what actions will be taken in this endeavor.

Payment System

It is really a liquidity management issue – The pressing issue related to payments is a corporate's ability to fund settlement associated with the payments services it provides. This is effectively a subset of the overnight and intra-day settlement and liquidity risks that corporates incur by being in the settlement services business. A corporate settles many classes of transactions including the payments it operates, payments others (e.g. Federal Reserve, banks, League Service Corporations, independent processors) operate, deposits and associated dividends, loans and associated payments, etc. The ANPR asks whether the payment services should be isolated from other services to separate the risks. Air Guard FCU believes that settlement of payments cannot be effectively separated and should be addressed in a broader context than just payments. This issue is addressed further under "Liquidity and Liquidity Management" below.

Corporates have managed other payment risks well – Corporates have offered payment services and managed the associated risks quite well for decades. In fact, part of the value corporates offer is mitigating some of their members' payment risks through corporates' payment offerings and associated settlement services. Assuming the primary issue of liquidity risk is addressed, there is little reason to believe that corporates cannot continue to operate their own, and distribute others', payment services successfully.

Corporates must offer payment and settlement services – The corporates are the primary financial institution (PFI) for most credit unions. To maintain this relationship, corporates must offer full lines of account services, settlement services, payment and correspondent services (regardless of whether they are operated or distributed by corporates), and short-term and intermediate-term investment and lending options. Eliminating any of these offerings reduces Air Guard FCU Response to NCUA the corporate's value as the cash management provider and risks losing the entire relationship to non-corporate providers.

Allocating capital for payment operations is appropriate – Corporates must fully understand all material risks to capital and should allocate an appropriate portion of their capital to all business lines (e.g. deposits, lending, settlement services, and payment services).

Corporates do not need to operate many of the payment services – Corporates need to offer and settle the products but do not necessarily need to operate many of the products in-house. Today, nearly all corporates distribute products operated by U.S. Central, Leagues, League Service Corporations, CUSOs, and non-credit union third parties. In many cases, they augment distributed products with value-added education, implementation services, support, and/or consulting. Most corporate in-house payment operations are for member and third party domestic wires, share draft, check collection deposits (and related image services), and corporate share draft. Though corporates have significant expertise and are offering some unique solutions to their members, there is little reason why these operations cannot be abstracted from the corporates' operations and processed by others.

Corporate payment operations should be consolidated – The redundant corporate payment operations limit corporate profitability, slow capital accumulation, and inflate fees to members. The fragmented nature also limits incremental and radical innovation, while the limited (regional) markets often make new products infeasible because required scale cannot be achieved. The industry should consider consolidating corporate payments, and potentially those of some other credit union-owned payment operations, to better serve credit unions. Though this consolidation would require several years and considerable expense to complete, the long-term strategic and financial benefits to the industry would be significant.

Suggested changes to regulation, rules, and other guidance – I believe the NCUA should consider the following when revising related regulation, rules, and other guidance:

- Require corporates to isolate certain payment operations from the core corporate and require that the business model be self-sustaining (have sufficient capital and profitability). This will likely encourage consolidation and/or out-sourcing to third parties.

- Eliminate the "excess capacity" provision for payment CUSOs that do not have a single majority owner. This would allow these separate entities to serve credit union business clients and non-credit union markets to amass greater scale, higher profitability, and accelerated capital accumulation.

Liquidity and Liquidity Management

Liquidity must continue to be a core service of the corporate system – The corporates are the primary financial institution (PFI) for most credit unions. To maintain this relationship, corporates must offer full lines of account services, settlement services, payment and correspondent services (regardless of whether they are operated or distributed by corporates), and short-term and intermediate-term investment and lending options. Eliminating any of these offerings reduces the corporate's value as the cash management provider and risks losing the entire relationship to non-corporate providers.

Corporates have historically managed liquidity risks well – Corporates have successfully managed their own liquidity while providing liquidity solutions for members through many difficult economic cycles. Unprecedented economic crisis severely tested even the best liquidity plans – The current unprecedented and catastrophic economic downturn has created a credit and liquidity crisis few imagined possible. The corporates have successfully accommodated dramatic decreases in deposits even without the ability to sell investment securities.

Require cash flow measurement and reporting – To effectively manage liquidity, corporates must have adequate measurement and reporting processes. To the extent corporates' processes are inadequate to properly assess their cash flows, regulators should require improvement under best practices and other guidance. Applicable methods include:

- Cash flow GAP modeling across prepayment ranges
- Limits on illiquid asset classes
- Limits on readily liquid assets and cash (minimums)
- Development of requirements for diversified funding sources
- In-depth contingency funding plans

Improve liquidity strategies, plans, and modeling – Corporates' liquidity plans have been effective during many difficult economic cycles. The recent crisis has underscored several best practices that should be employed (e.g. multiple borrowing sources, adequate cash reserves to cover unexpected short-term liquidity swings). Require modeling of liquidity plans for typical fluctuations in economic cycles.

Establish best practice of set-aside funding for settlement – Require corporates to set aside a portion of liquidity to specifically fund daily settlement. The set-aside must accommodate the timing of settlement of debits and credits as well as the daily, monthly, and annual cyclical activity levels. The allocation must be clearly identifiable from other activity and reserved for settlement only.

Enhance liquidity contingency plans to accommodate more dramatic scenarios – Stress liquidity plans by modeling performance under more dramatic scenarios and adjust liquidity requirements/sources accordingly. Require provisions to increase existing or add new sources of liquidity if limits are hit. One such tool may be to secure member balances as the primary source of liquidity for settlement services and allow the required level of deposit to be adjusted under extraordinary circumstances (such as what the market is currently experiencing). For example, require members to maintain a settlement account balance equal to 1 to 1.5 times a credit union's average or peak historical settlement activity. This is a common practice by some corporates today. The contingency plan may include triggers that increase this requirement to 1.5 or 2 times the average or peak activity in order to ensure adequate liquidity to continue settlement.

Improve the Central Liquidity Facility (CLF) – The CLF has proven to be an invaluable tool for the NCUA throughout the credit and liquidity crisis. However, the agency has encountered legislative barriers that prohibited or hampered their efforts to effectively address the crisis. Conduct a comprehensive evaluation of the CLF and advocate for changes that improve it as a tool for use by the NCUA and the industry.

Build corporate capital – Corporate capital has historically been adequate to weather economic cycles. However, this market crisis will redefine capital adequacy for all sectors of the financial services industry. Higher capital levels would provide corporates greater ability to either sell securities at a loss when liquidity is needed, or to hold securities that cannot be sold for a fair value (accommodate "Other Than Temporary Impairment (OTTI)"). Higher capital levels would also help the corporates retain higher ratings, preserving member balances and external sources of liquidity.

Field of Membership Issues

Impact of national fields of membership – Granting of national fields of membership did foster competition as well as increased risk-taking, as cited in the ANPR. It also contributed to:

- Margin compression, lower return on assets, and slower capital accumulation
- Better rates for member credit unions
- Fragmented innovation and product operations as corporates sought ways to gain advantages over other corporates
- Reduction in cooperation, trust, and utilization of shared resources such as U.S. Central

The Corporate Network must cooperate to succeed – With such low capital and low margins, corporates must find every way possible to leverage precious resources to meet member needs, widen margins, and accumulate capital. The primary areas where corporates should cooperate include payment operations, shared back office services, and innovation.

Eliminate or greatly reduce competition between corporates – Competition is nearly always a productive force. However, Air Guard FCU strongly believes that the value of mass cooperation among corporates will produce much greater value to credit unions than mass competition. The level of competition from numerous non-corporate providers is enough competition to ensure innovation, service, and competitive price levels.

The "Geographic FOM" alternative – One simple approach is to eliminate national FOMs and return to FOMs for the corporates' "home states" only. Enable corporates to distribute other corporates' investment and lending products, for a fee, to allow credit unions to diversify investments across multiple corporates without fostering the fierce competition that currently exists.
The "Preferred Corporate" alternative – A more practical alternative to the "Geographic FOM" approach is to allow each credit union to pick their primary corporate, regardless of location. This approach would involve the following:

- Require perpetual membership capital for a credit union to obtain services from a corporate
- Standardize capital requirements so that corporates do not compete over credit unions by lowering required capital levels
- Allow corporates to vary rates on perpetual membership capital to help build capital, then reward owners for financial performance of the corporate once minimum capital targets are met
- Allow limited portability of membership by permitting a credit union to sell their perpetual capital in one corporate and join another corporate (contributing perpetual capital to the new corporate). Include restrictions required for the perpetual capital to qualify as GAAP Tier 1 capital. Require Board of Director approval so that a corporate does not experience a catastrophic loss of capital if a group of credit unions changed during the same period. Govern unforeseen occurrences by requiring NCUA approval of such migrations
- Enable corporates to distribute other corporates' investment and lending products, for a fee. This would allow credit unions to diversify investments and liquidity sources across multiple corporates without fostering the fierce competition that currently exists
- Allow credit unions to directly diversify their investments and liquidity sources by establishing one or more relationships with "secondary" corporates. The credit union would be allowed to obtain select services (term investments, term loans) by depositing three-year term membership capital shares in proportion with the level of services utilized. Pricing of these products would be no better than what a "primary" member could obtain (to reduce competition for diversification services)

Expanded Investment Authority

Corporates are restricted to highly rated investments – Corporates are only allowed to purchase highly rated securities and have well-defined guidance for risk exposure. Regulation and guidance have evolved with the financial markets and have proven adequate prior to the current extreme credit and liquidity crisis.
Expanded investment authorities are appropriate tools – Corporates use expanded authorities to increase investment options (for both diversification and yield), create product offerings, mitigate risks (using derivatives), and facilitate member liquidity by participating in member loans. The tools have valid applications, and the competition outside the Corporate Network has these tools available to them. The question should be whether the corporate has appropriate expertise, systems, processes, and controls to utilize the tools effectively and safely.

The NCUA currently correlates eligibility and limits with capabilities – The agency currently grants specific authorities and sets limits based upon a corporate's capital, risk profile, and ability to utilize the tools effectively and safely. Access to expanded authorities requires significant investment in staff, systems, and process development. The bar is already set very high; adjust it as needed.
Setting more definitive guidance for required capital levels is appropriate – The agency currently considers many factors in granting authorities and setting limits. Agency staff members need latitude in this area. However capital levels should be a foundation requirement for additional authorities, so it seems reasonable that more definitive guidance be provided.

The NCUA currently conducts at least annual reviews of corporate authorities – Corporates with expanded authorities are subject to extensive and ongoing reviews by the NCUA that may result in changes to limits, moratoria on new use of authorities, suspension, or termination of authorities. If these processes are inadequate to determine whether the corporate can effectively and safely exercise the authorities, then the agency should consider enhancing these processes rather than layering on additional redundant processes.

Structure: Two-Tiered System

The Corporate System should be collapsed into a single tier – Many functions are replicated at the two tiers creating significant inefficiencies. Capital accumulation at both tiers is not feasible given current low margins and ROAs, prospective losses, and anticipated increases in capital requirements across the entire financial services industry. To gain efficiencies, improve margins, and accelerate accumulation of capital, one tier should be eliminated.

Single corporate and multiple corporate models are both viable – 1) A single national corporate would provide the greatest operating efficiency and can be more responsive to industry opportunities and challenges. However, all risk would be concentrated into a single organization. It is likely the percentage of credit union investable funds and borrowing currently held in corporates would drop as members would not have the option of diversifying across multiple corporates. 2) The multi-corporate options would spread risk but would also be less efficient. Under the current models, the fewer the corporates, the more efficient the network would become. These inefficiencies may be tempered somewhat if the level of competition was dramatically reduced and cooperation (e.g. consolidation of common functions such as payments, core technology, and innovation) was dramatically increased. Solutions for enabling credit union diversification of investments and borrowing across multiple corporates must be implemented to ensure that the network retains credit union business, increasing earnings and capital accumulation.

Elimination of a tier will spur consolidation of corporates and common corporate functions – Elimination of one tier will require all corporates to have the capability to effectively manage its investments, liquidity, risk and other functions. The more the corporates cooperate to create efficiencies (e.g. consolidate payments, share technology, cooperatively innovate), the greater the viability of the existing corporates. Ultimately, the marketplace, the level of cooperation, and the expenses to operate in a safe and sound manner will determine the number of corporate credit unions.

There is need for one or more central CUSOs – Whatever the number of corporates, certain functions should be consolidated for efficiency and to enable opportunity. At a minimum, this entails centralized payments, technology (core account processing, common electronic delivery channel), and innovation functions. Other opportunities to centralize functions for scale include risk modeling, member call centers, business lending, health banking and brokerage services. This action would require strong regulation and supervision of CUSOs by NCUA.

Limit services to members with any type of contributed capital – Limit access to the corporate's core services to those members that have contributed membership capital shares, term PIC, and perpetual PIC. As the Corporate Network is able to retire membership capital share and term PIC structures, users of services will all be perpetual PIC holders.

Index required MCS to usage of applicable services – MCS deposits have historically been indexed to assets with a cap on MCS over a specified asset size. A better approach may be to index MCS to the products that benefit from the capital deposits. This may vary across corporates. Allow adjustment between one and four times per year, in a manner that is reflective of the cyclical nature of the underlying products that MCS supports.

Create provision allowing credit unions to diversify investments and borrowing across multiple corporates – Credit unions need to diversify their portfolios. Enabling diversification across corporates meets this need, adds to the aggregate liquidity of the corporate network, and accelerates capital accumulation within the network. Two structures would accomplish this:

- Allow corporates to distribute other corporates' term certificates and term lending as brokered transactions. Limits would govern how much a corporate could distribute through other corporates in order to limit dilution of that corporate's capital and temper competition among corporates. Corporates should not be able to set rates for certificates and loans distributed by other corporates higher than what the issuing corporate's own members can obtain. This, plus a brokerage fee paid to the selling corporate, will temper competition

- Allow credit unions to directly diversify their investments and liquidity sources by establishing one or more relationships with "secondary" corporates. The credit union would be allowed to obtain select services (term investments, term loans) by depositing three-year term membership capital shares in proportion with the level of services utilized. Pricing of these products would be no better than what a "primary" member could obtain (to reduce competition for diversification services)

Establish risk-based capital requirements – Implement risk-based capital regulation in a manner consistent with other federally regulated financial institutions.

3. PERMISSIBLE INVESTMENTS

Corporate mission requires different investment authorities than credit unions – There is a natural dichotomy between the investment needs of corporates and natural person credit unions. Credit unions often use investments as an alternative to loans in periods of economic weakness or to more efficiently utilize excess liquidity (usually a small percentage of their total balance sheet.) Corporates, in their role as liquidity providers, should be solely focused on the liquid and shorter-term investment products. Credit union balance sheets carry investments primarily for cash/liquidity management, based on much smaller positions. Therefore credit union needs for a wide range of permissible investments, level of investment expertise, and extent of investment and risk infrastructure differs substantially from that of corporates. Credit union infrastructure and expertise is understandably more extensive and appropriately allocated to member lending activities. Whereas corporate balance sheets, which represent primarily investment of credit unions' liquid assets, need a wider range of short-term investment alternatives along with more extensive investment and risk management infrastructure and expertise.

Some currently authorized investment types should not be permissible or, if permissible, be subject to conditions – Of the types cited in the ANPR, NIMs and most CDO structures should not be permissible. Other investment types where the volatility of credit risk is leveraged through structure (e.g. when a 10% change in volatility results in a 100% change in the underlying risk posture) should be prohibited. Examples of investment types that should be prohibited or conditioned include long-term interest-only strips, long-term principal-only strips, and some types of leveraged floaters and inverse floaters.

New investment types should be made available only after review – Historically, there has been rapid development of investment types. Corporates were typically able to enter these investments on their own. There needs to be some process to effectively evaluate these new investment types in a timely manner before they are brought onto corporate balance sheets. Ideally, this review should be performed or validated by a qualified third party and/or the NCUA staff. This is particularly important if diversification/sector standards are initiated, as new asset classes will be seen as an attractive way to meet such diversification/sector requirements.

4. CREDIT RISK MANAGEMENT

Existing practices proved too reliant on ratings – Corporate regulation and credit risk practices used rating agencies as the predominant metric for evaluation of credit risk associated with investment securities. While this has been historically reliable, it proved inadequate throughout the current credit crisis, providing a false sense of confidence as ratings volatility and downward migrations have reached historic levels. Ratings, while predominant, were not the only metrics used to evaluate investment securities. Additional input included rating agency comments, analysis from other providers (brokers, analysts, and industry sources), internal modeling, historical performance of asset types, and forward looking reviews by industry experts.

Fix the rating agencies – The financial services industry must require significant improvement in the rating agencies' performance. The agencies must maintain their independence and minimize conflicts of interest between agencies and issuers.

Require ratings from multiple agencies – Improve practices by obtaining ratings from multiple agencies utilizing, or assigning greater weight to, the lowest rating. However, the industry should be cautious that obtaining multiple ratings can also provide a false sense of security as Air Guard FCU Response to NCUA Advance Notice of Proposed Rulemaking 15 current credit market dislocations were not accurately assessed by any of the rating agencies. We can hope that the use of multiple rating agencies in the future will prove more effective as the rating agencies revise their modeling, internal governance, and accountability to both investors and regulatory bodies.

Establish a regulatory review process for new security types – Obtain regulatory review of the appropriateness of new security types as they are created as well as existing types as the industry evolves. An alternative is to obtain an external review of any new asset class by a qualified external third party with appropriate levels of expertise and infrastructure to assess risk effectively.

Limit duration or cash flow structures – Establish rules to limit cash flows and duration of investment securities with the intent to minimize the potential impact of deterioration of credit spreads (as we have witnessed over the past 24 months).

Better defined and controlled concentration limits – New limits and controls are essential. However, there are prerequisites to implementing effective limits and controls. While "Obligor" is a well defined term, "sector" is not. Each investor has its own definition of sectors. A standard definition of sectors must be created and applied consistently across all corporates. Governance of this definition must be nimble enough to accommodate the pace of change in the industry (e.g. new asset classes). It is not feasible for this to be coded in regulation but should be governed by other agency guidance.

Target optimum, not maximum diversification – Diversification needs to be the hallmark of new guidance for corporates going forward. However, care must be taken to avoid unintended consequences of increasing risk (by tapping more risky sectors or accepting an inadequate risk/return ratio by over-diversification).

Establish independent evaluations of credit risk portfolios – These reviews would be conducted by qualified third parties with provider and statement-of-work approved by the regulators in advance. The costs of such reviews must be appropriately balanced with the risks and costs.

Test sensitivities to credit spread widening – Credit spread widening should be included as one of the risk parameters in the review of credit risk, and should be included in the reviews of interest rate and liquidity risk.

Change third-party reviewers every three years – Require corporates to change providers of external reviews periodically. This will ensure that the corporates' view of these risk categories are appropriate with current risk methodologies, new developments, and consistent with industry best practices.

5. ASSET LIABILITY MANAGEMENT

Reinstate requirement for modeling and stress testing net interest income – All corporates should model projected net interest income.

Establish requirement to model net income and NEV – All corporates should model net income and NEV as part of their monthly risk modeling and monitoring processes.

Encourage corporates to explore and utilize alternative methodologies – In addition to the standard required processes, corporates should explore the appropriateness and utility of employing concepts such as value at risk (VAR) and NEV utilizing total capital. As new tools and methodologies become available, corporates should always be examining new methods (without this being required by regulation).

Require modeling and testing of credit spread increases – The impact of recent market events exposes weaknesses that can be addressed by this important risk management process.

Require external reviews of all key risk processes – Corporates should obtain external validation of interest rate risk, credit risk, and liquidity risk processes and results (similar to the external validations that credit unions are required to obtain on their interest rate risk modeling). This will ensure that the corporates' view of these risk categories are appropriate with current risk methodologies, new developments, and consistent with industry best practices.

Anticipate and accommodate significant change over the next two years – The current crisis will prompt significant change in how the financial services industry views, measures, and manages risk. This will cause numerous changes to related best practices, tools, and technologies. Corporates and the NCUA must be able to understand and accommodate the coming change.

6. CORPORATE GOVERNANCE

Ensure minimum qualifications are commensurate with activities – Each corporate currently maintains minimum qualifications for Board and Committee members. Ensure that each corporate's minimum qualifications are commensurate with the activities of the corporate.

Require ongoing Board and Committee training – Require each corporate to maintain a training program commensurate with the activities of the corporate. Require documentation of attendance or documentation of qualification through testing.

Require Board and Committee peer reviews – Require each corporate to conduct annual peer reviews of their Board and Committee members. Require the Board to address deficiencies through training and/or prohibition of re-election.

Allow corporate Boards the option of outside directors – There are many arguments for and against outside directors. Air Guard FCU's own directors are split on whether to have outside Air Guard FCU Response to NCUA Advance Notice of Proposed Rulemaking 18 directors, leading us to believe that no single position should be imposed upon corporates or credit unions. Allow each corporate to determine whether to have outside directors and what number is appropriate. Prohibit outside directors from outnumbering directors from credit unions.

Allow corporate's Board or members to determine term limits – There are many arguments for and against term limits. Air Guard FCU's own directors are split on whether to have term limits leading us to believe that no single position should be imposed upon corporates or credit unions. Allow each corporate Board or their members to determine whether to have term limits and what limit is appropriate.

Allow corporate's Board or members to determine compensation – There are many arguments for and against director compensation. Air Guard FCU's own directors are split on whether to compensate directors leading us to believe that no single position should be imposed upon corporates or credit unions. Allow each corporate Board or their members to determine whether to compensate directors and what the compensation structure should be.

Apply credit union guidance to disclosure of corporate compensation information – Corporates should be subject to the same guidance as credit unions.

OTHER ISSUES

Retain Office of Corporate Credit Unions (OCCU) or equivalent function – The NCUA has indicated that it is considering elimination of the Office of Corporate Credit Unions (OCCU). Air Guard FCU believes that the agency should retain OCCU or an equivalent function. Corporate credit unions are unique in their purpose, balance sheet composition, product offerings, risk profile, etc. This requires regulation, guidance, and examination processes that are tailored to corporates.

Greater transparency: annual report of investment and risk functions – Improve transparency for member credit unions by requiring corporates to publish an annual report on the corporate's investment and risk management functions. At a minimum, it should include/address:

- A summary description of policies and procedures
- An overview of human and system infrastructure supporting investment and risk management functions
- A description of investment strategies
- Market outlook/perspective
- Risk metrics and positions
- Recap of that annual cycle's third-party reviews
- Summary of pertinent accounting policies

Greater transparency: monthly publication of financial, portfolio, and risk positions – Improve transparency for member credit unions by requiring corporates to publish monthly reports: financials and a summary of investment and risk positions.